B3700-1-4

FIRST CHICAGO
The First National Bank of Chicago

Analysis of Finance Company Ratios in 1989

Analysis of Finance Company Ratios in 1989

by Raymond M. Neihengen, Jr.

Each year, as we put together our annual survey of the finance company industry, we attempt to find a trend or development worthy of comment. This year there are certainly a lot to pick from including: capital adequacy and its potential impact on the pricing of bank credit facilities for the industry; the impact of the downturn in the real estate industry on the commercial finance industry; the demise of the junk bond market and its impact on the highly leveraged transaction portfolios of many commercial finance companies; and the disturbing trend in personal bankruptcies.

Our pick for this, the 54th Annual Survey of finance companies by The First National Bank of Chicago, is the bankruptcy issue. According to the Administrative Office of the U.S. Courts, during the period from 1979 to 1989 non business bankruptcy filings grew at a compound annual rate of almost 13%. Personal bankruptcy filings in 1989 were in excess of 600,000 with the percentage increases from 1988 varying between + 47% and + 28% (1st and 2nd judicial districts – New England and New York) and + 4% (5th judicial district – Texas, Louisiana and Mississippi).

In most articles on the subject easy credit, advertising by bankruptcy attorneys, the loosening of federal bankruptcy laws and even a decline in morality are cited as part of the litany of causes behind this trend. The facts are that our current body of law recognizes personal bankruptcy as a legitimate alternative open to the individual creditor. And, like any such alternative, it can be used properly or abused. As we see it, the industry can address the issue on a variety of fronts including: working towards legislative reform, employing tighter underwriting standards, supporting consumer education programs, adopting more aggressive enforcement of creditor rights and adjusting pricing to account for the cost of personal bankruptcies. We are not proposing any solutions, however, we are taking notice of the trend and suggest lenders to the industry query their customers on what steps they are taking to deal with the issue.

Consumer Finance (Direct Cash Lending) Companies

Earnings

For the consumer finance segment, earnings remained stable (Ratio 30) at 3.3%. There were, however, a number of swings in the profit equation as the industry experienced a one hundred and twenty basis point drop in the net interest margin (Ratio 26 minus Ratio 27). This was offset by a drop in the expense ratio (Ratio 28). A number of firms completed branch automation projects within the last several years and we believe, the benefits of these sys-

tems are showing up in this year's results. It should be noted that the provision for losses (Ratio 29) did not keep pace with the rise in the net charge offs ratio (Ratio 15) which led to a decline in the level of reserves to net charge-offs (Ratio 13) from 2.0 times to 1.9 times. Interest expense (Ratio 34) increased 110 basis points rising from 9.1% to 10.2%. This increase, when combined with relatively flat earnings led to a modest decline in interest coverage (Ratio 35) from 1.8 times to 1.7 times.

Portfolio Quality

Last year we commented that the drop in recency delinquency and the drop in net charge offs to average net receivables may signal a turn around in a multi-year trend of deteriorating portfolio quality. We appear to have spoken too soon as both recent delinquency (Ratio 10) and contractual delinquency (Ratio 11) increased to 2.6% and 3.9% respectively. Recoveries remained relatively stable at 17.5%.

The percentage of the portfolios made up of real estate loans (Ratio 4) and direct cash lending (Ratio 5) remains relatively stable. However, sales finance paper (Ratio 6) continues to increase, reflecting an emphasis observed over the past several years in this "feeder" business.

Leverage

For the first time in several years there was a slight decline in leverage (Ratios 21,22 and 23). This is attributable, we believe, more to a slowdown in growth (see Ratio 2) rather than any trend toward deleveraging the industry. It's also interesting to note that coverage of open market borrowings by bank lines of credit increased this year (Ratio 20). We believe this reflects a push by the rating agencies to increase line coverage in the face of some notable recent events in the commercial paper market. It should also be noted that the use of short term financing (Ratio 19) increased, significantly in response to the higher level of interest rates (See Ratio 34).

Diversified Finance Companies

Earnings

Much of the same pattern noticeable in the consumer finance sector was witnessed in the diversified sector. Net profit from Finance Operations (Ratio 29) was relatively flat at 2.2% versus 2.1% in 1988. Slightly higher yields, (Ratio 25), were not enough to offset the rise in interest expense (Ratio 26) so that the net margin declined by fifty basis points. A decline in both operating expenses (Ratio 27) and the loss provision (Ratio 28) offset this deterioration in net interest margin.

In contrast to the marked slowdown in the consumer sector, the diversified sector experienced a 12.5% growth in total outstandings (Ratio 2) but this growth, as noted above, did not translate into improved profitability.

Portfolio Quality

As in the consumer sector there was an increase in net charge offs to average net receivables rising from 1.1% to 1.3% (Ratio 13). Commercial delinquencies (Ratio 7) remained relatively flat at 2.6% while consumer delinquencies rose to 2.6% from 2.3% in the prior year. Ratio 9, percentage of Consumer Losses to Receivables Liquidated runs counter to this trend. A review of individual company performance indicates this is a function of a change in available data (one company with a relatively high loss to liquidation ratio is no longer publishing information). We attribute the increase in repossessions to net worth (Ratio 14) to the deterioration in the commercial real estate sector.

In both the consumer and the diversified sectors the provision for losses remained relatively constant. This trend has resulted in the Reserve for Losses to Net Receivables (Consumer Ratio 12 and Diversified Ratio 11) to remain relatively flat. Historically, in a period where there is some uncertainty regarding credit quality the industry has "beefed up" reserves. While it is too early to reach any definite conclusions, we believe that the changes in the tax laws regarding the methodology for establishing loss reserves are influencing this number.

Last year we noted that the diversified sector has developed portfolios of highly leveraged transactions. There are yet to be any noticeable differences between this portfolio segment's credit loss history and the historic loss ratios attributable to the commercial financial business. However, this segment has not yet experienced the full business cycle. In terms of disclosure, most firms are treating this segment like any other portfolio element. We would encourage more disclosure.

Leverage

Leverage also declined in the diversified sector following the same pattern as the consumer sector. While this is a break from a multi-year trend, we also attribute it to slower growth rather than any change in the pattern.

Conclusion

Most segments of the financial services industry have experienced difficult times of late. The finance company industry has run counter to this trend. While there may be some reason for caution when looking at its 1989 performance, the industry's results were once again excellent.

Consumer Finance (Direct Cash Lending) Company Ratios

Statement Date

Assets	
Volume for Period (Millions)	1
Total Outstanding (Millions)	2
Average Net Receivables (Millions)	3
% Direct Cash Loans (Real Estate Collateral) to Total Receivables	4
% Direct Cash Loans (Unsecured or Collateral Other Than Real Estate) to Total Receivables	5
% Retail Contracts to Total Receivables	6
Average Amount of Individual Loan Balances	7
% Loans to Present Borrowers	8
% Loans Written for Longer Than 60 Months	9
Asset Quality	
Past Due and Delinquent Accounts (Recency Basis) % Total Recency Delinquency	10
% Total Contractual Delinquency	11
% Reserve for Losses to Net Receivables	12
Ratio – Reserve for Losses to Total Charge-Offs Net of Recoveries	13
% Net Charge-Offs to Liquidations	14
% Net Charge-Offs to Average Net Receivables	15
% Recoveries on Loans Charged-Off	16

	12-31 1987	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
	10,270	23,016	20,591		
	28,767	35,987	36,355		
	1,996	2,354	2,384		
	38.19	33.0	34.5		
	51.85	49.7	48.1		
	12.75	14.2	15.9		
	2,592	3,075	2,758		
	57.23	59.1	61.6		
	14.07	14.1	14.6		
	2.80	2.4	2.6		
	3.77	3.8	3.9		
	3.10	2.9	3.0		
	1.49	2.0	1.9		
	3.21	3.3	3.7		
	2.22	2.1	2.2		
	15.90	17.3	17.5		

Consumer Finance (Direct Cash Lending) Company Ratios

Statement Date	
Liquidity	
% Average Monthly Cash Principal Collections to Average Net Monthly Outstandings	17
Number of Months' Collections Required to Pay Total Non-Subordinated Debt (Net of Cash) Applying % in Ratio #17 to Fiscal Date Net Outstandings	18
% Open Market Borrowings to Total Non-Subordinated Debt	19
% Unused Credit Facilities to Open Market Borrowings	20
Leverage/Capital Structure	
Ratio – Total Non-Subordinated Debt to Working Capital	21
Ratio – Total Liabilities to Tangible Net Worth	22
Ratio – Total Debt to Net Worth Plus Reserve for Loan Losses	23
% Subordinated Term Debt to Capital Funds	24
% Capital and Earned Surplus to Capital Funds	25
Earnings	
% Gross Finance Revenue to Average Net Receivables	26
% Interest Expense to Average Net Receivables	27
% Operating Expenses (Excluding Loss Provision) to Average Net Receivables	28
% Loss Provision to Average Net Receivables	29
% Net Finance Profit to Average Net Receivables	30
% Consolidated Net Income to Average Net Worth	31
% Consolidated Net Income to Average Total Assets	32
% Dividends to Consolidated Net Income	33
% Interest and Debt Expenses to Average Total Borrowings	34
Ratio – Times Interest Earned	35

	12-31 1987	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
	5.25	4.6	5.0		
	16.66	18.1	20.0		
	29.75	25.9	35.1		
	101.00	96.0	114.5		
	4.72	5.4	5.0		
	6.12	6.2	6.0		
	3.90	4.2	4.1		
	28.70	29.5	30.8		
	67.70	70.4	73.9		
	26.06	20.9	20.6		
	7.87	7.8	8.7		
	8.81	9.3	8.2		
	2.57	2.2	2.2		
	3.40	3.3	3.3		
	19.01	18.0	15.8		
	2.66	2.6	2.7		
	29.56	42.7	44.8		
	9.53	9.1	10.2		
	1.735	1.8	1.7		

Diversified Finance Company Ratios

Statement Date

Assets	
Volume for Period (Millions)	1
Total Outstandings (Millions)	2
Average Net Receivables (Millions)	3
% Retail Receivables to Total Receivables	4
% Direct Consumer Loans to Total Receivables	5
% Commercial Loans to Total Receivables	6
Asset Quality	
% Commercial Loan Balances With Installments Delinquent 60 Days or Over (Contractual Basis) to Total Related Receivables	7
% Consumer Loan Balances With Installments Delinquent 60 Days or Over (Contractual Basis) to Total Related Receivables	8
% Consumer Losses (Charge-Offs Net of Recoveries) to Consumer Receivables Liquidated	9
% Commercial Loan Losses (Charge-Offs Net of Recoveries) to Commercial Loans Liquidated	10
% Reserve for Losses to Net Receivables	11
Ratio – Reserve for Losses to Total Charge-Offs Net of Recoveries	12
% Net Charge-Offs to Average Net Receivables	13
Repossessions to Net Worth	14

12-31 1987	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
316,400	312,196	354,401		
226,400	276,348	310,923		
6,030	7,382	7,250		
45.0	42.0	42.9		
7.0	9.0	9.4		
48.0	49.0	47.6		
2.79	2.7	2.6		
2.38	2.3	2.6		
4.24	4.1	3.0		
1.22	1.2	1.1		
2.12	2.2	2.0		
2.25	2.3	2.5		
1.35	1.1	1.3		
4.10	4.0	7.0		

Diversified Finance Company Ratios

Statement Date	
Liquidity	
% Receivables Maturing Over 12 Months	15
% Cash, Wholesale, Fast Turning Commercial Loans and Installment Receivables Maturing in 12 Months to Total Non-Subordinated Debt	16
Number of Months' Collections Required to Pay Total Non-Subordinated Debt (Net of Cash, Wholesale, and Fast Turning Commercial Loans)	17
% Commercial Paper Borrowings to Total Non-Subordinated Debt	18
% Unused Credit Facilities to Commercial Paper Borrowings	19
Leverage/Capital Structure	
Ratio – Total Non-Subordinated Debt to Working Capital	20
Ratio – Total Liabilities to Tangible Net Worth	21
Ratio – Total Debt to Net Worth Plus Reserve for Loan Losses	22
% Subordinated Term Debt to Capital Funds	23
% Capital and Earned Surplus to Capital Funds	24
Earnings	
% Gross Finance Revenue to Average Net Receivables	25
% Interest Expense to Average Net Receivables	26
% Operating Expenses (Excluding Loss Provision) to Average Net Receivables	27
% Loss Provision to Average Net Receivables	28
% Net Profit From Finance Operations to Average Net Receivables	29
% Consolidated Net Income to Average Net Worth	30
% Consolidated Net Income to Average Total Assets	31
% Dividends to Consolidated Net Income	32
% Interest and Debt Expenses to Average Total Borrowings	33
Ratio – Times Interest Earned	34

	12-31 1987	*12-31 1988*	*12-31 1989*	*12-31 1990*	*12-31 1991*
	60.25	59.4	61.8		
	45.68	43.9	43.7		
	39.41	41.9	32.7		
	46.65	46.0	46.7		
	82.53	76.4	97.1		
	8.31	8.5	8.5		
	8.29	8.7	8.3		
	5.71	5.8	5.8		
	25.33	24.0	22.5		
	74.68	78.0	79.9		
	14.38	14.4	15.0		
	6.77	7.0	8.1		
	3.87	3.6	3.4		
	1.64	1.5	1.2		
	1.85	2.1	2.2		
	15.04	15.7	15.0		
	1.52	1.9	1.9		
	51.88	40.5	49.9		
	7.89	8.4	9.4		
	1.38	1.4	1.3		

FIRST CHICAGO
The First National Bank of Chicago

Financial Services Division
One First National Plaza
Mail Suite 0084
Chicago, Illinois 60670-0084

(312) 732-6237

Material very similar to this will appear in the September 1990 issue of *The Journal of Commercial Bank Lending*.

3365